NEWSLETTER NO. 30

WHAT DO YOU NEED TO DO BY DECEMBER 31, 2008?

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Accounting for tangible capital assets (TCA) will be mandatory for all Canadian municipalities as of January 1, 2009. There has been much discussion and attention given to the identification and cataloguing of tangible capital assets, and to the valuation of these assets as of that date. However, tangible capital asset accounting is also an on-going exercise, in perpetuity, which begins January 2, 2009, to keep your asset records current, and to be able to prepare financial reports as and when required.

It is important to understand what may be needed for such day-to-day tangible capital asset accounting. This newsletter will try to help you to identify and address those on-going requirements in a timely manner – by December 31, 2008.

Public Sector Accounting Handbook Section PS 3150 has transitional provisions for local governments. PS 3150.43 states "*This Section applies to local governments for fiscal years beginning on or after January 1, 2009. Earlier adoption is encouraged.*"

Since the fiscal year is the same as the calendar year for Ontario municipalities, that means no later than the start of the very first business day **next year**. This is not just for annual financial reporting, but full compliance with all 48 paragraphs of Section 3150.

What are the on-going activities?

With the move to full accrual accounting for tangible capital assets, the following activities will have to be carried out on an on-going basis:

1) maintaining appropriate policies and procedures for tangible capital asset accounting;
2) maintaining and updating the tangible capital asset inventories as and when required;
3) recording and documenting all acquisitions of tangible capital assets;
4) recording and documenting all disposals and sales of tangible capital assets;
5) recording and documenting all gifts, contributions and pro bono transfers of tangible capital assets, whether into or out of the municipal organization;

6) recording the writing down of tangible capital asset valuations, when appropriate;
7) recording and documenting the write-off of tangible capital assets, when appropriate;

8) calculating the amortization expense for tangible capital assets and posting journal entries to record it in the accounts of the municipality;
9) preparing monthly, quarterly and annual reports as required, for the municipality as a whole and by operations unit; and
10) facilitating the annual audit

What do you need to have in place to meet the on-going requirements?

These tasks are fairly straightforward, and the activities complement what you are already doing for your asset inventories. However, there are specific requirements that you should give consideration to in terms of on-going tangible capital asset accounting, because this is not a one-time exercise. Because you will want to be prepared to go live on January 2, 2009, that means that these requirements have to be identified, and specified as what and how they will be addressed within **the next few months**. Whatever staffing, products or services may be needed to make it happen next year will have to be acquired and brought on-line and tested or trained before the end of this year.

There are four major areas of concern which we will look at in turn.

1) What will you need going forward?

This has four not-so-minor areas of concern.

1a) Accounting policies

Early on, you need to establish rules as to how TCA accounting is to be carried out in your municipality. This is not putting the cart before the horse. Rough out what you see as the rules you want the staff of your organization to play by, with respect to TCA accounting. Brainstorm, and include whatever you think you may need. Your policies will not be carved in stone, and may change over time.

In establishing your policies, it may be useful to involve those who will administer the policies on day-to-day basis. For example, engineers and other asset managers could be particularly useful in establishing things like capitalization thresholds. You will likely want to include senior management such as the CAO since what you do in the policy will have implications for resources and systems. Also, systems should not be developed in isolation of asset managers. There could be synergy and integration benefits from leveraging asset management systems, budgeting and accounting systems.

There are samples in the OMBI Reference Manual and in the CICA Guide to Accounting for Tangible Capital Assets. You can also see some accounting policies of several municipalities at the PSAB/Asset Management website. Use them if they will be a helpful starting point, or copy from another municipality that has gone through this exercise. Get something drafted, so that you have a sense of what you have to do as an organization and as individual staff members, and what you expect to achieve.

Sample issues that you may want to include are:

- authority, purpose and scope;
- asset definition;
- asset categories;
- single asset versus component approach (segmentation);
- asset valuation (cost, contributed or donated assets, grants or donations, etc.);
- capitalization policies (buildings, library books, computer software, land and land improvements);
- recognition thresholds;
- capitalization of carrying costs;
- betterments versus maintenance;
- amortization methodology and rates;
- reviews of estimated useful life and write-down for impairment;
- capital leases;
- asset ledgers (content, maintenance, periodic inventories);
- control (asset inventory, maintaining records and documentation);
- construction-in-progress (when to start amortizing);
- surplus assets;
- asset disposal (sale, abandonment, demolition, trade-in); and
- risk management, health and safety issues and environmental issues

1b) Data, data storage and maintenance

Electronic Storage. You will almost certainly start by storing your asset data as Excel spreadsheets, though you may quickly want to implement an asset accounting module. Both approaches were discussed in detail in Newsletter #28 on software. These issues were also discussed in the PSAB seminars delivered in the fall of 2007.

Hard Copy Records. For your asset inventory, you will have created a hard-copy audit file, which will have sufficient documentation to substantiate the value assigned to each individual asset. This need will continue for all new acquisitions, though you may well capture much more in your asset accounting system, if you implement one. At the same time, the auditor may still want to consult such documentation when reviewing your reporting on acquisitions.

For accounting purposes, once the TCA data has been audited, you probably could send these asset files to archives, or off-site storage. Then again, you may want them around for asset management or other reasons.

1c) Asset accounting tools

This was discussed at some length in Newsletter #28 on software. You will want to consider:

- transaction volumes;
- availability of asset data banks elsewhere; and
- extent to which you need/want automation.

1d) Decisions on staff resources - who will do it?

Who and where will the on-going updating of asset inventories that you will require take place? You are between a rock and a hard place, because the accounting staff don't generally see what's coming in and going out, they only hear about it. And operations staff are not interested in "bean counting," as they are glad it has arrived, and need to get it into use as fast as possible. This is yet another reason for involving those who will administer the policies in the establishment of the policies.

Do not overlook training. Ensure that your staff knows what is required. This is a very major accounting change, forcing a very different way of thinking on municipalities with respect to capital assets. When did you ever contemplate and record the profit or loss on the disposition of a municipal asset before?

TCA accounting and reporting is not intuitively obvious, but neither is it unfathomable. Communicate to your staff about what is happening. If you can do that yourself, that is so much the better, because you know your audience and your business best. If not, get outside help, or send them to workshops. Use whatever resources are available.

2) How will you operate day to day?

This covers on-going activities that will start next year. Think and plan this year how your organization will carry them out, so that you and your staff will be prepared and ready to go on January 2, 2009. What policies and procedures do you need to have in place, to be satisfied that they will be done properly and in full?

2a) Acquisitions and dispositions

These will be easier to document, as you can capture the information as it is happening. Also, you will have actual costs to the penny, so that no estimating will be required. As you create an

asset data sheet for each new acquisition, you can easily collect whatever supporting documentation will be required for the audit file.

Acquisitions are fairly easy to capture, as they have to be paid for. Accounting will be aware of them, even if it is post facto. Donations and transfers will be more of a challenge, and why you need to have your accounting policies in place. They will instruct the receiving parties as to how they are to record and report such assets.

Dispositions will be more of a challenge. Not everything goes to auction. After something has outlived its useful life to us, it may be quietly donated to some needy unit that can find a use for it, or if no-one wants it, may go into a disposal bin and to landfill. All that can and will still happen.

One of the more difficult situations to deal with will be assets that are "abandoned." The engineer goes out and tears up a sidewalk, replaces a section of sewer pipe or upgrades a section of a street. As far as the engineer is concerned, he uses the backhoe to dig up the old and replaces it with the new. It is one project to him, but it involves two transactions - a disposal and addition. What is the system you will use for notifying the TCA accountant that the two transactions have occurred?

But if such an asset is in your TCA inventory, then its disposition needs to be recorded, and accounted for, and the TCA values adjusted appropriately. How will you know or check on what is happening? Your policies will encourage proper reporting, but will not enforce it.

2b) Write downs and write offs

These are new concepts for municipal accounting. There are circumstances where technology has made an asset obsolete, or there are more fuel-efficient alternatives, for example. In many cases a write down is "event driven." Something has happened that suggests you have to review the asset(s) for impairment. For example, in a one industry town, the closing of the industry would require a review of TCAs for impairment. There could be a change in environmental legislative standards that affect the operation of a water treatment plant or a wastewater treatment plant. Or perhaps the clientele for whom you created a facility have all moved away. The asset has not been completely amortized, and therefore has a net book value. But the value to you of any future benefits is substantially less than the current book value.

You will then be writing the value down to reflect a fairer value for the asset, and the write-down will be expensed against operations. Please note that the guidelines do not allow for writing up values at all. Also, PS3150.33 states, "*A write-down should not be reversed.*" You cannot change your mind later. What policies will you need to be able to manage these effectively?

2c) Betterments and maintenance

You have to spend some money on a tangible capital asset during its useful life. Will that be a betterment or just maintenance? A betterment is a cost incurred to enhance the service potential of an asset (PS3150.19). Does it:

- Extend life expectancy?
- Increase output or capacity?
- Improve the quality of output or service?
- Lower operating costs?

A betterment will leave you better off than when you first acquired the asset. You may have had to do the work to keep it going, but what you did has added value above and beyond the original value. On the other hand, maintenance just keeps the asset going, without additional value or functionality being provided. The asset performs like new, but no more and no less.

- Betterments can be capitalized (PS3150.19 and .21(b))
- Maintenance has to be expensed (PS3150.21(a))

This difference in accounting treatment is why this will be a big issue going forward for all of you, and will be the subject of many animated discussions with your operations people. From an operations perspective, betterment is like buying something on credit, at 0% interest, whereas maintenance is paying in full with cash on delivery.
It should be noted that you can establish "thresholds" for betterments. A threshold could be an absolute dollar amount or a percentage of the cost of asset. Decisions on component versus whole asset approach could also impact capitalization of expenditures.

Who will be the arbiter of differences of opinion on this? Who will have the last word?

2d) Directly attributable costs

You may capitalize costs such as:

- Installation/set-up costs;
- Design and engineering fees;
- Legal fees;
- Survey costs;
- Site preparation costs, including disposal costs;
- Freight charges;
- Transportation insurance costs;
- Custom duties and taxes;
- Permits and fees;

- Environmental assessment study costs;
- Meetings and hearings costs;
- Project management costs; and
- Inspection and testing costs

Anything can be included in an asset's gross cost, as long as it relates **directly** to the acquisition of the asset, and the cost would not have been incurred, if you had not bought the asset. Thus if you have a design engineer whose time is **completely billed** out to projects, then you can capitalize his time spent on a specific construction project. On the other hand, it would not be appropriate to allocate a portion of the costs of the City Engineer's department just because it may be involved in administration or the costs of the human resource department or accounts payable department because they issue the payments.

How will you ensure that you allocate or assign these costs to the appropriate asset acquisition?

You can and should have a policy to charge out carrying costs and interest on interim financing for capital acquisitions. PS 3150.15 states that "The cost of a tangible capital asset…includes carrying costs …such as interest costs when the government's policy is to capitalize interest costs. Capitalization is optional. Note that if you have a policy to capitalize interest, then interest must be capitalized for all assets acquired, developed or constructed over time. A government cannot be selective. When deciding how to treat interest, bear in mind that it may be difficult to isolate those interest costs directly attributable with a project. For example, if there is a central treasury function that does general borrowing, which funds did I borrow for general purposes and which did I borrow for the capital project?

2e) Capitalization of assets

The capitalization of an asset is to occur when the asset is ready for productive use (PS 3150.18). This may depend on the circumstances in which the asset is to be operation, e.g. customizing of vehicles for use.

The date of capitalization is a mater of fact, and is not discretionary. You cannot keep the books open because there are deficiencies, holdbacks, liens, warranties and claims outstanding that have to be settled. Capitalization goes ahead regardless, and if the amounts involved are significant, you can always revise the asset's capitalized gross cost post facto. Or simply expense those costs.

Capitalization means that someone will process a journal entry to move the asset from work-in-progress over to the appropriate asset inventory, along with all the costs associated with its acquisition. A life expectancy will be assigned manually or automatically, and amortization will begin. In short, your acquisition has become another one of your thousands of assets.

That is what is supposed to happen. On the other hand,

- The bills will not all be in until sometime after the asset has gone into service.
- Accounting is for the fiscal year, not the fiscal day.
- You may want to capitalize at year-end, but assume a mid-year capitalization date for amortization.
- If an asset has gone into use by year-end, capitalize it – there is no “or else”….

You don’t generally prepare financial statements as of today’s date, so that you may well decide to do the capitalization entries as part of the year-end accounting, at least for all the very large value assets. You can always backdate the transfer journal for the asset to the day that it did go into service, so that the historical record complies with the guideline, but does capture all the attributable costs.

The easiest and most reasonable way to amortize your assets is to use straight-line amortization over the expected useful life, and unless you want to expense on a monthly basis (another reason to buy an asset accounting module, perhaps), expense it in January for the assets on hand as of January 1st, and at year-end, enter the amortization relating to acquisitions and dispositions during the year at 50% of the annual rate, as though everything happened on July 1st.

Currently, **“Works-In-Progress”** are all capital expenditures, and reported as such. Come 2009, everything in the works is to be reported as “works in progress” or “assets under development”. And all directly attributable costs can be charged to work in progress, including the cost of interim financing, if any. As stated earlier, when the asset is put in productive use, it is moved from work-in-progress to another category and amortized.

How will you prepare your staff to do all this as and when it will happen?

3) What accounting issues will you have to address?

3a) Transfers, donations and contribution of assets

Transfers and donations may be either into or out of your municipality, from someone to you, or from you to someone. The same applies to transfers between you and any of your agencies, boards and commissions. Coming or going, you will have to account for them, starting as of January 1, 2009. The biggest issue here will be tracking these transfers, as there may be no formal agreement or documentation, unless your accounting policies require there to be something in writing. Also, accounting may not be aware as to when the transfer is taking place. What will you need to have in place to be sure that you are made aware?

3b) On-going capitalization thresholds

Like the assets themselves, your tangible capital asset accounting policies won't last forever, particularly your capitalization thresholds. If Canada were to experience hyper-inflation like Zimbabwe's, tomorrow's stapler would cost more than today's capitalization threshold.

You may want to test the sensitivity of your capitalization thresholds from time to time. If you doubled your threshold value, would you substantially reduce the number of asset records to be maintained, for minimal value of assets excluded? You do not have to, of course, but in the years to come, occasionally step back and look at what you are doing, and ask: - Are these assumptions still valid? - Is this approach still working? - Do I need to change that policy? And so on. Build this flexibility into your accounting policies.

3c) What will you include or exclude from inventory?

Staff will always try to test the limits in their favour. This is another case where your accounting policies can support you, and head off many potential "discussions".

And it cannot be stressed often enough that the accounting for the acquisition of a tangible capital assets is not affected by how it was budgeted or financed. Is it tangible or have physical form? No? – then expense it. Yes? OK, then is it over the threshold? –capitalized. Under the threshold? – expensed.

3d) Completeness and accuracy of data

Unfortunately, you will have an on-going internal control issue with respect to your assets, because you need to track them, as well as know that they are being looked after. There is also a quality control issue with respect to your tangible capital asset data. If you don't track disposals well, your inventories will suffer from bloat.

On the other hand, you will have more up-to-date historical data as assets are replaced or upgraded. You should also have more complete data, as you fill in any missing blanks in your inventories over time, and discover those items that may unfortunately have been overlooked the first time around. It happens.

The acid test for all your preparations this year, to put sound policies, procedures and systems in place, is when your auditor reviews your annual changes in future years for completeness, accuracy and materiality. This will essentially be a review of what happened during the fiscal year, with the starting balance as an accepted given.

Whoever signs your financial statements now will be signing off on your TCA figures as well. You are strongly urged to have your operating managers sign off on their individual asset

inventories each year. Be upfront with your managers, that they will be taking ownership of the financial data on their tangible capital assets.

This approach has a lot to commend it. First, your managers cannot disagree with or dispute something on which they have signed off. Second, it further encourages them to see capital assets as long-term investments, to be prudently managed. Third and most important, you will have an endorsement of your numbers from those who are in a good position to know what is actually out there.

4) What will be your financial reporting requirements?

Besides what your municipality may decide to do for internal management purposes, you will publish

Revamped municipal financial statements, starting with fiscal 2009
Revamped Ontario Financial Information Return (to Ministry), starting with fiscal 2009 (see the draft 2009 FIR)

These will be addressed at length in a monograph scheduled to be released in the fall of 2008, and in guidelines to be issued by the Ministry of Municipal Affairs and Housing, respectively. However, for these financial reports and for any management reports, what tangible capital asset data will you need to populate these reports? What policies, procedures and systems do you need to have in place to provide you with reliable data? Will all that be ready for January 1, 2009?

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NOTE: This Newsletter is an adaptation of a presentation given at the MFOA/AMCTO PSAB Fall 2007 Workshops.

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Having talked here about on-going asset accounting, our next newsletter will look at another accounting change that you should have already taken care of. Or have you? Segmentation, or reporting by business segment.

For more information and resources regarding tangible capital asset management, go to PSAB/Asset Management or contact:

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NOTE: This Newsletter is published to assist you with your implementation of tangible capital asset accounting and with related matters. The Public Sector Accounting Handbook is the only authoritative primary source on matters relating to GAAP, and you should consult with your auditor to resolve specific issues that you may have.